

**Not All Available Information Was Considered
When Examining Tax Returns at the Austin
Campus During the Fiscal Year 2000
Earned Income Credit Initiative**

December 2002

Reference Number: 2003-40-037

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

December 18, 2002

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

Gordon C. Milbourn III

FROM: Gordon C. Milbourn III
Acting Deputy Inspector General for Audit

SUBJECT: Final Audit Report - Not All Available Information Was
Considered When Examining Tax Returns at the Austin Campus
During the Fiscal Year 2000 Earned Income Credit Initiative
(Audit # 200240054)

This report presents the results of our review to determine whether employees at the Internal Revenue Service's (IRS) Austin Campus appropriately closed correspondence examinations and considered available systemic information, specifically where it relates to the self-employment income reported by taxpayers and the Earned Income Credit (EIC) available to them.

This audit was in response to a congressional inquiry by Senator Phil Gramm (Republican-Texas) based on an allegation that the IRS' Austin Campus management directed employees to incorrectly close examination cases worked as part of the IRS' Fiscal Year (FY) 2000 EIC Initiative. The Treasury Inspector General for Tax Administration's Office of Investigations reviewed the information and referred the inquiry to the Office of Audit to determine if the IRS followed appropriate procedures in this matter.

In summary, tax returns examined as part of this initiative were closed inappropriately without the IRS considering systemic information to verify taxpayers' self-employment income. This happened because the guidelines for working examination cases during the FY 2000 EIC Initiative at the Austin Campus were confusing and in conflict with general IRS examination guidelines.

IRS employees were instructed to make adjustments to taxpayers' income tax returns. These adjustments included: disallowing self-employment income and related expenses, decreasing or eliminating the self-employment tax, and disallowing the EIC

claimed without researching the IRS' computer system¹ to determine if third-party information² had been reported to the IRS. In addition, whether the adjustments were made depended on when the examination case was processed and if the Examination quality assurance group reviewed the case.³ This resulted in the unequal treatment of taxpayers.

Management's Response: IRS management agreed with the recommendation and has requested guidance from Chief Counsel to determine the effect of the disallowance of the self-employment income on Social Security quarter credits and taxpayers' rights.

Management's complete response to the draft report is included as Appendix V.

Copies of this report are also being sent to the IRS managers who are affected by the report recommendation. Please contact me at (202) 622-6510 if you have questions or Michael R. Phillips, Assistant Inspector General for Audit (Wage and Investment Income Programs), at (202) 927-0597.

¹ The IRS' computer system, the Integrated Data Retrieval System, is used for accessing tax information on taxpayer accounts. It enables employees to perform such tasks as researching account information, requesting tax returns, and entering examination and collection information. It contains income information that third parties (payors) provide the IRS that can be used to verify taxpayers' reported wage and self-employment income.

² Payors of self-employment income are required to report to the IRS the amounts paid using Miscellaneous Income (Form 1099-MISC) when they pay at least \$600 to an individual. When received, the IRS inputs this third-party information into its computer system.

³ The Examination quality assurance group performs reviews of closed examination cases worked at the Austin Campus to ensure all procedures and standards have been followed properly and the cases worked appropriately.

**Not All Available Information Was Considered When Examining
Tax Returns at the Austin Campus During the Fiscal Year 2000
Earned Income Credit Initiative**

Table of Contents

Background	Page 1
Taxpayer Accounts Were Adjusted Without Considering All Available Systemic Information.....	Page 4
<u>Recommendation 1:</u>	Page 9
Appendix I – Detailed Objective, Scope, and Methodology	Page 10
Appendix II – Major Contributors to This Report.....	Page 11
Appendix III – Report Distribution List	Page 12
Appendix IV – Outcome Measures	Page 13
Appendix V – Management’s Response to the Draft Report	Page 14

**Not All Available Information Was Considered When Examining
Tax Returns at the Austin Campus During the Fiscal Year 2000
Earned Income Credit Initiative**

Background

The Treasury Inspector General for Tax Administration (TIGTA) received a congressional inquiry from Senator Phil Gramm (Republican-Texas) regarding an allegation made by Internal Revenue Service (IRS) employees that the Compliance function at the IRS' Austin Campus incorrectly closed examination cases during the Fiscal Year (FY) 2000 Earned Income Credit (EIC) Initiative. Specifically, the allegation was that IRS employees were directed by management to close cases for assessment without researching the IRS' computer system¹ to verify self-employment income reported by taxpayers who also claimed the EIC on their tax returns. The TIGTA's Office of Investigations reviewed the information and referred the inquiry to the Office of Audit to determine if the IRS followed appropriate procedures in this matter.

These cases were included in two projects² worked as part of the FY 2000 EIC Initiative. The projects were developed through compliance research on refund fraud. Criteria were developed to identify tax returns with pre-determined characteristics that were considered high-risk for refund fraud. These criteria were then loaded into the IRS' Electronic Fraud Detection System (EFDS)³ as filters. If the tax returns met filter criteria, the system selected them for examination.

Although the EFDS filters had other criteria, the distinguishing selection criterion for these tax returns was that the taxpayers reported self-employment income and claimed the EIC. The majority of the tax returns included in

¹ The IRS' computer system, the Integrated Data Retrieval System, is used for accessing tax information on taxpayer accounts. It enables employees to perform such tasks as researching account information, requesting tax returns, and entering examination and collection information. It contains income information that third parties (payors) provide the IRS that can be used to verify taxpayers' reported wage and self-employment income.

² The review focused on returns that were in the Earned Income Tax Credit (EITC) *Schedule C Preparer TY 1999* and *EITC Schedule C TY 1999* projects.

³ An IRS system that accesses all electronically filed returns that have been scored for potential fraud.

**Not All Available Information Was Considered When Examining
Tax Returns at the Austin Campus During the Fiscal Year 2000
Earned Income Credit Initiative**

the FY 2000 EIC Initiative were for Tax Year (TY) 1999, but late-filed TYs 1997 and 1998 tax returns were also included.

With few exceptions, National Headquarters Examination froze the tax refunds and sent initial contact letters to the taxpayers by June 2000. These letters informed taxpayers that the IRS had frozen their tax refunds and would be examining their tax returns. The returns were then assigned to individual IRS campuses to be classified.⁴

The Austin Campus expected to classify the FY 2000 EIC Initiative tax returns and send a second letter to taxpayers within the 30 days required by project guidelines. This second letter asked the taxpayers to substantiate the self-employment income and provide support for dependent exemptions and the EIC. However, Austin Campus management explained that, because of system problems, the Austin Campus did not send these letters to the taxpayers for approximately 3 months. In addition, since the projects were behind schedule, they decided not to classify the tax returns before contacting the taxpayers.

If taxpayers responded to the Austin Campus' Examination letters with support for the self-employment income and the EIC, the returns were to be accepted as filed. If the taxpayers responded but could not provide sufficient support, if the taxpayers did not respond, or if the letters were returned to the IRS as undeliverable, the IRS was to issue a *Statutory Notice of Deficiency*⁵ and the taxpayers' accounts were to be adjusted.

The taxpayers' accounts were adjusted by either one or all of the following:

- Disallowing the reported self-employment income and related expenses.

⁴ Classification is a pre-screening process to determine if a return should be examined and what issues should be questioned.

⁵ The final notice that is issued to the taxpayer before the IRS assesses additional tax.

**Not All Available Information Was Considered When Examining
Tax Returns at the Austin Campus During the Fiscal Year 2000
Earned Income Credit Initiative**

- Disallowing the qualifying children and the EIC claimed.
- Decreasing the income tax.
- Decreasing or eliminating the self-employment tax.

The IRS reports adjustments to self-employment income to the Social Security Administration (SSA). The SSA uses the IRS' information to adjust the taxpayers' Social Security quarter credits.

Throughout the examination process, the IRS offers taxpayers who disagree with proposed adjustments the opportunity to appeal the proposed adjustments. Taxpayers can appeal proposed adjustments to a local Appeals Office, which is separate and independent of the local IRS office, campus, or compliance center. After the *Statutory Notice of Deficiency* is issued, taxpayers have the right to file a petition with the Tax Court.

This review was performed in the IRS National Headquarters; the Wage and Investment (W&I) Division National Headquarters; the EIC Program Office; and the Austin, Brookhaven, and Philadelphia Campuses between April and August 2002. The audit was conducted in accordance with *Government Auditing Standards*.

Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

The IRS employees who made the allegation provided the TIGTA with five examination cases to use as examples of cases that had been incorrectly closed at IRS management's direction. A total of 2,758 cases in the FY 2000 EIC Initiative were worked at the Austin Campus. We limited our review to those five cases and the directives and guidance provided by Austin Campus Compliance management to IRS employees working the FY 2000 EIC Initiative cases. However, we also contacted personnel in other campuses and in the National Headquarters to identify appropriate procedures and determine what procedures are currently being used.

**Not All Available Information Was Considered When Examining
Tax Returns at the Austin Campus During the Fiscal Year 2000
Earned Income Credit Initiative**

**Taxpayer Accounts Were
Adjusted Without Considering
All Available Systemic
Information**

We will be performing a follow-up review to determine if the same practices used at the Austin Campus were used when working cases for the FY 2000 EIC Initiative in other campuses and to quantify the total impact on taxpayers. We will also determine if procedures in the FYs 2000 and 2001 EIC Initiatives were appropriate and are currently being used in any subsequent initiatives.

Tax returns examined as part of the IRS' FY 2000 EIC Initiative (cases) were closed inappropriately without the IRS considering systemic information to verify taxpayers' self-employment income. This happened because the guidelines for working examination cases during the FY 2000 EIC Initiative at the Austin Campus were confusing and in conflict with general IRS examination guidelines.

A review of five cases worked during the initiative showed that the IRS adjusted the self-employment income reported on all five tax returns.⁶ As a result, taxpayers lost rights and entitlements and the government lost revenue. Specifically:

- Three of the 5 taxpayers lost 12 Social Security quarter credits to which they were entitled. When and if these taxpayers realize they did not receive the credit for these quarters, they will have to prove they earned this income to the SSA before they are eligible to receive the correct amount of Social Security benefits.

The remaining two taxpayers received Social Security quarter credits even though the IRS disallowed the net self-employment income. One taxpayer had sufficient wages to meet the Social Security quarter requirements. Another taxpayer responded to the IRS but provided insufficient information. The IRS disallowed the net self-employment income and reduced the self-employment taxes, but when closing out the case, did not properly complete the closing document to advise the SSA to remove the taxpayer's quarter credits.

⁶ In addition, the IRS disallowed the exemptions for the dependents. This and the adjustment to the self-employment income resulted in the disallowance of the EIC.

**Not All Available Information Was Considered When Examining
Tax Returns at the Austin Campus During the Fiscal Year 2000
Earned Income Credit Initiative**

- Five taxpayers had a total of \$6,976 in unassessed self-employment taxes. In addition, the revenue from the interest and penalties that should have been assessed for these unpaid taxes was lost.
- Five taxpayers had a total of \$3,647 in unassessed income taxes. In addition, the revenue from the interest and penalties that should have been assessed for these unpaid taxes was lost.

The Internal Revenue Manual (IRM) requires that research be completed before returns are assigned for examination, including researching the IRS' computers to determine:

- The taxpayer's complete filing history.
- Detailed information on individual tax years.
- Taxpayer sources of income and payor information.

The IRM also lists standards that should be met for quality examinations. Two of these standards measure whether:

- Consideration is given to the Classified/Program as well as large unusual or questionable items during the course of the examination.
- The examined issues are completed to the extent necessary to provide the examiner sufficient information to determine the substantially correct tax based on the correct application of tax law.

Research was not completed before classification and assignment, and was not always completed when working the cases

The Austin Campus did not classify the FY 2000 EIC Initiative tax returns or research the IRS' computer system for historical information to determine if the taxpayer had a history of self-employment income or current self-employment income before assigning the cases. Austin Campus Compliance management did not believe that there were sufficient resources to perform this research, and they

**Not All Available Information Was Considered When Examining
Tax Returns at the Austin Campus During the Fiscal Year 2000
Earned Income Credit Initiative**

stated that TY 1999 third-party information⁷ was not available when the processing for these tax returns began.⁸

In addition, the guidelines for the initiative relied on advice that the Office of Chief Counsel provided in Calendar Year 1998 when the Chief, Examination Branch, at the Brookhaven Service Center asked about the appropriateness of disregarding net earnings from self-employment income when taxpayers are claiming the EIC. This advice stated that when taxpayers do not comply with requests for substantiation of the income or if record keeping requirements have not been met, the net earnings from self-employment income may be disregarded, thereby eliminating the taxpayers' EIC. However, the advice did not address whether the IRS should research IRS systems and consider income reported by third parties to the IRS.

Also, throughout the initiative, Austin Campus Compliance management issued guidelines (directives) that conflicted with the IRM or provided instructions that reversed prior directives. For example, tax examiners were instructed to consider available third-party information for open cases and then later instructed to check third-party information only if the taxpayer responded.

A directive was also issued for the FY 2001 EIC Initiative that instructed tax examiners to check third-party information and, if present for the prior tax year, assume the taxpayer had self-employment income for the current year. Though this directive was issued for the FY 2001 EIC Initiative, the same tax examiners working the FY 2000 EIC Initiative were working cases in the FY 2001 EIC Initiative.

⁷ Payors of self-employment income are required to report to the IRS the amounts paid using Miscellaneous Income (Form 1099-MISC) when they pay at least \$600 to an individual. When received, the IRS inputs this third-party information into its computer system.

⁸ Third-party information provided by the payor is not available on the IRS computer system until September of the year the tax return is required to be filed.

**Not All Available Information Was Considered When Examining
Tax Returns at the Austin Campus During the Fiscal Year 2000
Earned Income Credit Initiative**

**Research was not completed when third-party
information became available**

When third-party information for TY 1999 became available on the IRS' systems, the IRS had already issued the *Statutory Notice of Deficiency* to many of the taxpayers. IRS procedures do not require additional research on cases where the taxpayers have been issued this notice. This policy normally applies when deductions or credits are being denied and there is no additional information available on the IRS' computer systems.

Tax examiners were at one time instructed to perform research on completed examinations. However, Austin Campus Compliance management later issued a memorandum with a policy change stating that National Headquarters Examination had instructed the campuses to remove the self-employment income and that additional research would not be required on completed examinations.

Some tax examiners attempted to determine if the reported self-employment income was valid. Austin Campus Compliance management directed the employees to stop the research, disregard the third-party information that might support taxpayers' claims, and finalize the assessments if the *Statutory Notice of Deficiency* had been issued. Management instructed the employees to follow this procedure because, as they explained to employees, there is no other program requirement mandating continuous, unlimited, and indefinite research in order to finalize examination cases.

However, the FY 2000 EIC Initiative continued for more than a year after the initial processing started, and initial research for third-party information had not been performed on these cases. Although we believe that the IRS' policy of not performing additional research after the issuance of the *Statutory Notice of Deficiency* is reasonable under normal circumstances, we believe that additional research should have been performed on these cases before the final assessments were made to taxpayers' accounts to ensure taxpayers were not adversely affected.

**Not All Available Information Was Considered When Examining
Tax Returns at the Austin Campus During the Fiscal Year 2000
Earned Income Credit Initiative**

The Austin Campus' Examination quality assurance group⁹ took exception to cases reviewed where its research showed third-party income reported to the IRS

The Examination quality assurance group at the Austin Campus reviewed a small sample of the FY 2000 EIC Initiative examinations. When it determined that the tax examiners did not consider all available third-party information, it returned the cases to the examination groups to complete the research and counted these cases as having errors. Austin Campus Compliance management disagreed with this determination and did not change their policies.

Even though Austin Campus Compliance management disagreed with the quality assurance position, some IRS employees were allowed to research for third-party information and correct a number of cases rejected by the Examination quality assurance group. After the corrections were made, a new *Statutory Notice of Deficiency* was issued to the taxpayers to make assessments on the other adjustments made to the EIC and dependents claimed.

The actions taken during the FY 2000 EIC Initiative resulted in unequal treatment of taxpayers. However, during the FY 2001 EIC Initiative, Austin Campus Compliance management issued new procedures requiring the tax examiners to research the IRS' computer system for historical third-party information before disallowing self-employment income. In addition, this step was built into the automated screening filters for the processing of the FY 2002 EIC Initiative tax returns nationwide.

Since the IRS now has guidelines in place and has implemented new procedures that should help preclude this from happening again in other EIC initiatives, we are not making any recommendations to implement new procedures at this time. However, in our follow-up review, we will determine if the new guidelines and procedures are in place

⁹ The Examination quality assurance group performs reviews of closed examination cases worked in the Austin Campus to ensure all procedures and standards have been followed properly and the cases worked appropriately.

**Not All Available Information Was Considered When Examining
Tax Returns at the Austin Campus During the Fiscal Year 2000
Earned Income Credit Initiative**

and effective in helping to prevent inconsistent
EIC Initiative examinations.

Recommendation

1. The Commissioner, W&I Division, should consult with the Office of Chief Counsel to determine the effect of the disallowance of taxpayers' self-employment income and Social Security quarter credits and whether the IRS' actions violated the taxpayers' rights or entitlements.

Management's Response: The Commissioner, W&I Division, has requested guidance from Chief Counsel to determine the effect of the disallowance of the self-employment income on Social Security quarter credits and taxpayers' rights.

**Not All Available Information Was Considered When Examining
Tax Returns at the Austin Campus During the Fiscal Year 2000
Earned Income Credit Initiative**

Appendix I

Detailed Objective, Scope, and Methodology

The objective of this review was to determine whether employees at the Internal Revenue Service's (IRS) Austin Campus appropriately closed correspondence examinations and considered available systemic information,¹ specifically where it relates to the self-employment income reported by taxpayers and the Earned Income Credit available to them.

To complete our objective, we:

- I. Interviewed the IRS National Headquarters Examination and Austin Campus Compliance management on the guidance provided to tax examiners and the time period that the guidance was applicable.
- II. Reviewed the IRS' case files and secured other pertinent documents on five examination cases documented in the Office of Investigations referral to determine if the Austin Campus disallowed taxpayers' reported self-employment income without considering available third-party² provided income data. IRS employees who made the allegation provided the Treasury Inspector General for Tax Administration with five examination cases to use as examples of cases that had been incorrectly closed at IRS management's direction.
 - We contacted the Social Security Administration for its quarter credit computation methodology.
 - We analyzed and computed the Social Security quarter credits associated with the IRS' disallowance of valid self-employment income for the five cases.
- III. Interviewed IRS National Headquarters Examination and Austin Campus Compliance management on corrective actions the IRS took to rectify the disallowance of valid self-employment income on cases where third-party reported income information supported the taxpayers' claims. Additionally, we interviewed management at the Brookhaven and Philadelphia Campuses on the current examination case screening practices.

¹ The IRS' computer system, the Integrated Data Retrieval System, is used for accessing tax information on taxpayer accounts. It enables employees to perform such tasks as researching account information, requesting tax returns, and entering examination and collection information. It contains income information that third parties (payors) provide the IRS that can be used to verify taxpayers' reported wage and self-employment income.

² Payors of self-employment income are required to report to the IRS the amounts paid using Miscellaneous Income (Form 1099-MISC) when they pay at least \$600 to an individual. When received, the IRS inputs this third-party information into its computer system.

**Not All Available Information Was Considered When Examining
Tax Returns at the Austin Campus During the Fiscal Year 2000
Earned Income Credit Initiative**

Appendix II

Major Contributors to This Report

Michael R. Phillips, Assistant Inspector General for Audit (Wage and Investment Income Programs)

Augusta R. Cook, Director

Bryce Kisler, Audit Manager

Sharon Summers, Senior Auditor

Julia Tai, Senior Auditor

Sylvia Sloan-Copeland, Auditor

**Not All Available Information Was Considered When Examining
Tax Returns at the Austin Campus During the Fiscal Year 2000
Earned Income Credit Initiative**

Appendix III

Report Distribution List

Acting Commissioner N:C
Deputy Commissioner, Wage and Investment Division W
Director, Compliance W:CP
Director, Strategy and Finance W:S
Chief Counsel CC
Director, Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis N:ADC:R:O
National Taxpayer Advocate TA
Office of Management Controls N:CFO:F:M
Audit Liaison:
 Program/Process Assistant Coordinator, Wage and Investment Division W:HR

**Not All Available Information Was Considered When Examining
Tax Returns at the Austin Campus During the Fiscal Year 2000
Earned Income Credit Initiative**

Appendix IV

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. These benefits will be incorporated into our Semiannual Report to the Congress.

Type and Value of Outcome Measure:

- Taxpayer Rights and Entitlements – Actual; 3 taxpayers affected when the Internal Revenue Service (IRS) disallowed the taxpayers' self-employment income for a total loss of 12 Social Security quarter credits (see page 4).

Methodology Used to Measure the Reported Benefit:

We researched the IRS' computer system¹ and contacted the Social Security Administration to calculate the number of Social Security quarter credits lost by these taxpayers.

Type and Value of Outcome Measure:

- Increased Revenue – Actual; 5 taxpayers affected when the IRS did not assess \$6,976 in self-employment taxes (see page 4).

Methodology Used to Measure the Reported Benefit:

We researched the IRS' computer system to determine the amount of self-employment tax that should have been assessed by the IRS.

Type and Value of Outcome Measure:

- Increased Revenue – Actual; 5 taxpayers affected when the IRS did not assess \$3,647 in income taxes (see page 4).

Methodology Used to Measure the Reported Benefit:

We researched the IRS' computer system to determine the amount of income tax that should have been assessed by the IRS.

¹ The IRS' computer system, the Integrated Data Retrieval System, is used for accessing tax information on taxpayer accounts. It enables employees to perform such tasks as researching account information, requesting tax returns, and entering examination and collection information. It contains income information that third parties (payers) provide the IRS that can be used to verify taxpayers' reported wage and self-employment income.

**Not All Available Information Was Considered When Examining
Tax Returns at the Austin Campus During the Fiscal Year 2000
Earned Income Credit Initiative**

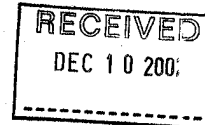
Appendix V

Management's Response to the Draft Report

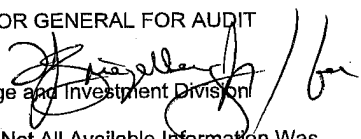


DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

December 10, 2002



MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: John M. Dalrymple 
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report: Not All Available Information Was
Considered When Examining Tax Returns at the Austin Campus
During the Fiscal Year (FY) 2000 Earned Income Credit (EIC)
Initiative (Audit # 200240054)

In FY 2000, the IRS initiated over 45,000 Schedule C audits where the EIC was questioned. The uniform guidance we give tax examiners for conducting EIC audits is the subject of ongoing review. We also frequently request guidance from the Office of Chief Counsel, and this guidance is incorporated into the guidelines developed by National Headquarters. Adherence to guidelines issued by National Headquarters is assessed through the Quality Review System throughout the year.

We agree that our guidelines for examining tax returns in connection with the FY 2000 EIC initiative were unclear. This was especially true as it relates for verifying the self-employment income taxpayers reported and the EIC available to them. However, Criminal Investigation referred these returns to Examination because they met criteria considered high risk for refund fraud:

- The income shown on them met the requirements to receive the maximum EIC amount.
- The business activity that generated the income was unusual.
- The taxpayers failed to respond to several requests for additional information.

Contrary to national guidelines, prior to assigning these returns for examination at the Austin Campus, research of taxpayer filing history and sources of income and payer information was not conducted. While these returns were subject to such pre-examination screening prior to assignment at the other campuses as noted in your report, the returns of any taxpayers that responded to IRS requests for additional information to substantiate questionable self-employment income or EIC claims were accepted as filed, including returns examined by the Austin Campus. Also as noted in your report, throughout the examination process IRS offers taxpayers that disagree with proposed adjustments the opportunity to appeal and, after the statutory notice of

**Not All Available Information Was Considered When Examining
Tax Returns at the Austin Campus During the Fiscal Year 2000
Earned Income Credit Initiative**

2

deficiency is issued, taxpayers retain the right to file a petition with the Tax Court to challenge any such deficiency.

As your report acknowledges, Austin Campus Compliance management issued new procedures during the FY 2001 initiative requiring tax examiners to research the IRS' computer system for historical third-party information before disallowing self-employment income and related EIC claims. We also added this step to the automated screening filters, which will look at prior year U.S. Information Return, Form 1099s, to establish that a business existed. If the system shows prior 1099s, we will not select the return for the questionable Form 1040 Schedule C issue. We will have this in place for the nationwide processing of FY 2003 EIC initiative tax returns.

We have also drafted a memorandum with instructions to the field that states employees should not deviate from the IRM until they receive approval from the Director, Reporting Compliance. The memorandum further states employees must request deviations in writing.

We agree with the Outcome Measures in your report. Our response to your specific recommendation follows:

RECOMMENDATION

The Commissioner, Wage and Investment Division, should consult with the Office of Chief Counsel to determine the effect of the disallowance of taxpayers' self-employment income and Social Security quarter credits and whether the IRS' actions violated the taxpayers' rights or entitlements.

ASSESSMENT OF CAUSE

At least 5 tax returns audited as part of the IRS' FY 2000 EIC Initiative were closed inappropriately without considering systemic information to verify taxpayers' self-employment income. Guidelines for working examination cases during the initiative at the Austin Campus were confusing. TIGTA's review showed that in 3 of the 5 cases, taxpayers lost Social Security credits to which they were entitled.

CORRECTIVE ACTION

We have requested guidance from Chief Counsel to determine the effect of the disallowance of the self-employment income on Social Security quarter credits and on taxpayers' rights.

IMPLEMENTATION DATE

February 1, 2003

RESPONSIBLE OFFICIAL

Director, Reporting Compliance, Wage and Investment Division

**Not All Available Information Was Considered When Examining
Tax Returns at the Austin Campus During the Fiscal Year 2000
Earned Income Credit Initiative**

3

CORRECTIVE ACTION MONITORING PLAN

Not Applicable

If you have any questions, please call William Zachery, Director, Reporting Compliance at (404) 338-7684.